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January 10, 2005

Mary L. Cottrell, Secretary
Department of Telecommunications and Energy
One South Station, 2nd Floor
Boston, Massachusetts 02110

RE: Default Service, D.T.E. 04-115

Dear Secretary Cottrell:

On December 6, 2004, the Department of Telecommunications and Energy (the "Department") issued a Notice of Filing and Request for Comments ("Notice") on the procurement of default service power supply for residential and small commercial and industrial ("C&I") customers. The Department requests comments on the advantages and disadvantages of several possible modifications to current default service procurement policies: (1) increasing the number of solicitations used to procure default service supply; (2) using supply terms greater than twelve months; (3) using a statewide approach to default service procurement; (4) using an auction process (e.g., descending clock) to procure default service; and (5) using a new term other than "default service" to describe the type of service defined in G.L. c. 164, § 1. Notice, pp. 5-6.

Pursuant to the Department's December 6, 2004 notice, the Attorney General submits this letter as his Comments on the procurement of default service power supply.

I. EXECUTIVE SUMMARY

The Department is seeking comments on the modification of current policies for the procurement of default service for the residential and small C&I customers. The wholesale electric market, however, currently is experiencing major uncertainties stemming from on-going

federal regulatory measures. The Department should continue its policy announced in D.T.E. 02-40-B of maximizing consumer welfare by minimizing long-term costs to consumers while maintaining a safe and reliable default service.

The Attorney General supports the basic concepts embodied in the Department's questions—longer contract terms, a statewide auction and the renaming of Default Service. However, given the complexity of the issues involved, the Department should open an investigation to fully explore the specific impact of any modifications it may be considering and to develop the necessary rules and regulations for successful implementation of any changes.

II. INTRODUCTION

The General Court has determined that “electricity service is essential to the health and well-being of all residents of the commonwealth, to public safety, and to orderly and sustainable economic development,” and that “affordable electric service should be available to all consumers on reasonable terms and conditions.” *Electric Utility Restructuring Act of 1997* (“Act”) St. 1997, c. 164, §1. The Legislature recognized that the transition from a monopoly-regulated electricity market to a competitive market structure would take time and would require a service of last resort or default service for those customers who, for whatever reason, were unable to secure standard offer service or competitive service in the restructured market. The Legislature's intent was that service of last resort, or default service, was the means of ensuring that all customers in Massachusetts have universal access to electricity.¹

The Department has opened a number of investigations to ensure that the manner in which default service is provided is compatible with the development of an efficient competitive market so that the benefits of a competitive market are available to all Massachusetts consumers at the end of the standard offer transition period. *See Pricing and Procurement of Default Service*, D.T.E. 99-60 (1999); *Metering and Billing*, D.T.E. 01-28 (2001); *Competitive Market Initiatives*, D.T.E. 01-54 (2001); *Provision of Default Service*, D.T.E. 02-40 (2002). The Attorney General has consistently advocated for the use of longer term contracts in the procurement of default service. *See, e.g.*, D.T.E. 02-40. The Department, however, has only slowly moved toward adopting that proposal, so it is timely now for the Department to once again review the effectiveness of the current default service policies² since the seven-year transition period established in the Electric Restructuring Act of 1997 will end on February 1, 2005 and, on March 1, 2005, all remaining standard offer service customers will become default

¹ General Laws Chapter 164, Section 1B(d) requires that “the department shall ensure universal service for all ratepayers”

² Currently, distribution companies procure 50 percent of their default service supply for residential and small C&I customers semi-annually through competitive solicitations for twelve-month terms, with the default service rate set for six months. *See* D.T.E. 02-40-B. The Department approved this procurement strategy to strike a balance between providing sufficient price certainty and efficient price signals. *Id.*, p. 44.

service customers. During the review and possible modification of its default service procurement policies, it is important for the Department to carry out the Legislature's intention "that electric service will be available at a reasonable price, consistent with each person's need to access electricity to function in modern society. . . ." D.T.E. 02-40-B, p. 7.

III. PRINCIPLES FOR PROCUREMENT OF DEFAULT SERVICE

The wholesale market upon which retail electric service depends continues to experience major structural changes that ultimately affect the procurement and price of default service. Since the enactment of the 1997 Restructuring Act, the Federal Energy Regulatory Commission ("FERC") has undertaken a series of steps to change the wholesale electric markets, including the implementation of locational marginal pricing, designed to send more accurate price signals to constrained areas on the transmission system; the elimination of "seams" issues through Standard Market Design; and the creation of day ahead markets, forward reserves markets, the currently proposed LICAP "market" and pending changes to other "markets."³ Each of these FERC changes to the wholesale markets has an effect on retail markets and on default service procurement and pricing.⁴ For example, the LICAP market, if implemented as scheduled in 2006, alone would increase costs to consumers in New England in excess of \$10 billion during the first 5 years of operation.⁵ Until the wholesale market rules have been in place and have a proven track record of predictable results, the Department should proceed cautiously as it considers changes to the current pricing and procurement design of default service.⁶

³ In its Standard Market Design Notice of Proposed Rule making ("NOPR"), FERC clearly and unequivocally stated that the transition to competitive electricity markets has not fulfilled the promise to provide more customer choice and lower average electric rates. FERC noted that the California electricity crisis, the collapse of Enron, the allegations of improper trading practices, and the financial deterioration of many energy suppliers and marketers has "added unprecedented uncertainty about, and lack of confidence in, today's electric markets." *Remedying Undue Discrimination through Open Access Transmission Service and Standard Electricity Market Design*, 67 Fed. Reg. 55452, 55467 (August 29, 2002). FERC has been making sweeping changes in the wholesale market to remedy this situation.

⁴ The LICAP demand curve will create challenges for Default or Standard Offer Service solicitations. *Devon Power LLC, et al.*, Order on Compliance Rehearing and Clarification, 109 FERC ¶61,154, 61,631 (November 5, 2004).

⁵ According to testimony filed with FERC, the ISO's proposal would result in the Boston/Northeast Mass. market area customers paying almost 3 cents /kWh more in 2010. *Devon Power LLC, et al.*, 107 FERC ¶61,240, (June 2, 2004), Exhibit Mass AG-1.

⁶ Significant questions have been raised in the LICAP proceedings about the creation of LICAP zones and the impact this may have on market power, in addition to concerns raised about the cost and effectiveness of the ISO-NE LICAP proposal. See *Devon Power LLC, et al.*, 107 FERC ¶61,240 (June 2, 2004). Default service must be designed in such a way that it does not exacerbate market power or increase customer costs unnecessarily.

During the course of this proceeding the Department may receive numerous proposals concerning how to modify the procurement of default service. The Department should evaluate these proposals according to a set of principles that ensures that the cost to provide default service is minimized, the process does not result in customer confusion, and the procurement process provides a level of price stability to customers without alternatives. Default service procurement procedures and policies also should be structured to minimize the potential for wholesale market abuses.⁷

Beginning March 1, 2005, approximately 95 percent of residential electricity consumption and 90 percent of small C&I electricity consumption will be provided through default service.⁸ Default service will, in all likelihood, be the primary service for the majority of customers. The focus of any Department consideration of modifications in the default service procurement policies should be whether customers will benefit rather than whether competitive suppliers or the competitive market will benefit. The Department, therefore, should adhere to these guiding principles as it considers modifications to the procurement policies:

- A. The overall objective of restructuring was and remains to produce real benefits for all customers, and all proposals for change must be measured against this standard.
- B. Restructuring and wholesale competition have produced substantial benefits for customers, although opportunities for direct access to retail markets have developed at a different pace for different customer groups.
- C. Smaller customers have not had significant access to competitive retail electric markets; residential, and especially low-income customers, may not have viable, reasonably priced retail competitive options.
- D. Default Service provided by local utilities may be the only viable energy option for small, residential and low-income customers for the foreseeable future; such service provides a valuable means of delivering the benefits of the competitive market to those customers, and should continue to be offered to them.
- E. Default Service prices should not be below the costs incurred to procure Default Service from the competitive market -- this ensures that Default Service rates are not subsidized and thereby create an artificial price barrier to retail competition.

⁷ “[T]he function of the department is the protection of public interests and not the promotion of private interests.” *Lowell Gas Light Company v. Department of Public Utilities*, 319 Mass. 46, 52, (1946). See *Massachusetts Institute of Technology v. Department of Public Utilities*, 425 Mass. 856, 873, fn. 38 (1997).

⁸ These percentages were derived from the October 2004 customer migration statistics found at the Division of Energy Resources’ website at http://www.mass.gov/doer/pub_info/0410.xls

- F. Customers should not be forced to pay rates for Default Service that exceed the market-based, competitively established costs to serve them so that even those customers who do not have viable, direct access to retail competition will continue to benefit from competitive markets.
- G. Retail *choice* should be maintained.

IV. ANSWERS TO THE DEPARTMENT'S QUESTIONS

The Attorney General generally supports the concepts that are the focus of the Department's questions – longer contract terms, a statewide auction and the renaming of Default Service.⁹

Question 1: Would smaller customers be better served if power supply for default service is procured using a portfolio of more than two solicitations? Please discuss the advantages and disadvantages of increasing the number of solicitations used to procure default service supply.

RESPONSE:

Yes, smaller customers would be better served if their power supply was procured through more solicitations to create a portfolio of supply contracts.¹⁰ The greater number of solicitations would diversify the risk associated with acquiring power for these customers.

The portfolio of contracts would have the advantage of reducing the variability of the price to customers if the contracts were allowed to extend over a number of years. The portfolio could also reduce the price to customers, assuming suppliers were willing to lower prices for longer guarantees of price support. It would also diversify the risk of supply itself, since it would tend to decrease the risk due to default by increasing the number of suppliers, and also decrease the risk of the cutoff of supply caused by the actions of any one generating source.

A supply portfolio would have the disadvantage of creating a price that will vary

⁹ The Attorney General's Comments are intended to respond to the general framework or outline that the Department has proposed for discussion. The issues involved with formulating a specific procurement plan are numerous and complex, however, and further Department proceedings and discussions with interested parties will be necessary to fully explore the details of any proposed modifications to the procurement and pricing of default service, if the Department decides that it is in the public interest to make changes.

¹⁰ Although the number of solicitations would increase to create the portfolio, those solicitations could all be done at one time each year.

from the current spot price for power, although this can be considered to be the tradeoff that is required to achieve greater price stability. Another disadvantage to the portfolio, depending on the length of the contracts, is that there could be some stranded costs associated with longer contracts if customers migrate from the service to competitive service or otherwise, in the future.¹¹

Question 2: Would smaller customers be better served if power supply for default service was procured for a term longer than twelve months? Please describe the advantages and disadvantages of using supply terms greater than twelve months. In particular, please discuss:

- a. whether longer contract terms are likely to produce lower prices,
- b. how such an approach would affect price certainty and market efficiency, and
- c. how such an approach could be tailored to accommodate customer migration to competitive supply.

RESPONSE:

Yes, smaller customers would benefit from power contracts being procured with terms longer than twelve months.

The advantages of using contracts of longer term include: (1) the reduced variability of the portfolio price; (2) the possibility of a lower price for default service; and (3) a greater diversity of supply.

- a. whether longer contract terms are likely to produce lower prices:

Longer term contracts could produce lower prices, all other things being equal. Of course, FERC decisions affecting the wholesales markets could also have an impact on prices. *See Devon Power LLC, et al.*, Order on Compliance Rehearing and Clarification, 109 FERC ¶61,154, 61,634 (November 5, 2004).

- b. how such an approach would affect price certainty and market efficiency:

The use of a portfolio containing both longer term and spot priced contracts results in benefits to all stakeholders. Long-term contracts should lead to more price certainty because these contract prices should be more stable than the prices under the current procurement scheme. Competitive retail suppliers will have a more stable and longer term price to beat. Long-term contracts will also create

¹¹ As discussed below, however, this disadvantage may be mitigated with appropriate structuring of the portfolio.

more certainty for investment in generation, which should improve that market.

- c. how such an approach could be tailored to accommodate customer migration to competitive supply:

The portfolio of contracts should be tailored in the short-run to accommodate the possibility that customers will migrate to other supply options, whether it be competitive supply, municipal aggregation, or some other provider. Laddering the contracts and keeping significant amounts of the contracts less than a year in term should provide the necessary flexibility to reduce the contracted supply if customers migrate.

- Question 3: Would smaller customers be better served if power supply for default service was procured on a statewide basis? Please discuss the advantages and disadvantages of using a statewide approach to default service procurement.

RESPONSE:

Yes, there are distinct advantages to procuring default service through a single statewide auction. Small customer groups may be aggregated across utilities to mitigate adverse price impacts associated with loads that are too small to hedge. Prices will reflect the same market conditions--this may also be disadvantage of statewide procurements, but any disadvantage can be ameliorated by segmenting the amount of load each utility is offering at each annual auction. A statewide procurement would also have the advantage of providing relatively uniform prices across the state for power. Although there might be unavoidable price differences due to geographic location, it would mitigate price differences due to timing, distribution company creditworthiness, and distribution company procurement costs. Furthermore, statewide pricing would reduce a barrier to competition, since it would reduce the utility-to-utility price differentials that retail competitors would have to beat to acquire customers.

- Question 4: Would smaller customers be better served if power supply for default service was procured using an auction process (e.g. descending clock auction) rather than through requests for proposals? Please discuss the advantages and disadvantages of using an auction process to procure default service. In particular, please discuss whether using an auction is likely to produce lower default service prices.

RESPONSE:

Smaller customers would benefit from an open auction where more bidding information is made available to the bidders, since it usually leads to a more efficient process, and in this case, lower price bids, than the Request For Proposal

(“RFP”) alternative. The implementation of a descending clock auction in New Jersey provides an instructive example of this type of procurement. The New Jersey auction is administered by an independent firm and observed and reported on to the New Jersey Commission by another independent consultant.

If the auction proceedings are reviewed and reported to the Commission, any flaw may be corrected for the next round, assuring the process incorporates improvements and necessary changes over time.

A disadvantage of descending clock auctions, however, is that they are relatively complex procurements compared to closed bid auctions, but the literature and research on properly run descending clock auctions both indicate that they provide more efficient results.

Question 5. Although the term “default service” is statutory, G.L. c. 164, § 1, it has confused some customers because of its unintended suggestion of nonfeasance in performing a legal or contractual obligation. Is there some better or more descriptive term that ought to be used by the distribution companies on and after March 2005?

RESPONSE:

A clean break from the term “default service” on March 1, 2005, with a change to the term BASIC SERVICE, would be appropriate, not only to avoid any negative connotation associated with the “default service” label, but also to indicate that it is a new day for smaller customers.

The Department also invited “proposals regarding the number of solicitations that, in conjunction with procurement terms and the manner of procurement, will best ensure that smaller customers receive benefits.”

A. Number of Solicitations

A solicitation scheme designed to develop a diversified portfolio of contracts could be divided into four parts comprised of 10 percent spot, 30 percent one-year contracts, 30 percent two-year contracts, and 30 percent three-year contracts. After two years of transition to develop the portfolio of contracts, the solicitation would be an annual event with 10 percent of the load reserved for spot purchases, 30 percent one-year contracts, 15 percent two-year contracts, and 10 percent three-year contracts. The following table illustrates how this would be done each year for a firm with 1000 megawatts of load:

ANNUAL SOLICITATION MEGAWATT CONTRACTS

<u>Contract Term</u>	<u>Contract Vintage</u>	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Spot		100	100	100	100
One-Year					
	2005	650			
	2006		400		
	2007			300	
	2008				300
Two-Year					
	2005	150	150		
	2006		150	150	
	2007			150	150
	2008				150
Three-Year					
	2005	100	100	100	
	2006		100	100	100
	2007			100	100
	2008				100
TOTAL SUPPLY		1000	1000	1000	1000

B. Procurement Terms

Appropriate terms for the solicitation process depend on whether the auction is statewide or company specific. Company specific RFPs could be continued as are currently done. Companies issue RFPs and evaluate the bids. The results and the evaluation data are submitted to the Department for approval. This method allows utilities to maintain their current procurement operations and procedures.

A statewide procurement lends itself to auctions like the New Jersey process where an independent auctioneer conducts the auction, bids are for an individual utility company's load and result in separate prices for each utility. The New Jersey Commission has an independent consultant observe the auction and report to the Commission on various aspects of the auction process. This method has a proven track record, would provide a uniform process and results across the state, and would allow the aggregation of small loads to mitigate the price effect of buying power in small lots.

Another statewide model is the Maine procurement process, an RFP process that is conducted under the authority of the Commission and the resulting prices are equivalent to tariffed rates. There are no contracts between suppliers and the utilities for electricity supplied. The Maine process may not be easily transported to Massachusetts because of the lack of supply contracts with utilities.

C. Manner of Procurement

The default service procurement schedule illustration in A. Number of Solicitations demonstrates the results of annually procuring supplies with terms of 1, 2, and 3 years with a small portion of the total requirement met with spot purchases. The annual procurements could be done on either on a statewide basis or by individual companies using RFPs. Annual auctions could be for load following blocks of power for one year, two years, three years. The one year procurement would represent 30 percent of the current year's requirement, the two year procurement would be for 15 percent and the three year term procurement would be for 10 percent. In any given year, beyond a transition phase, the supply would be made up of 10 percent spot, 30 percent one year contract, 30 percent two year contracts (15 percent new and 15 percent procured in the prior year) and 30 percent three year contracts (10 percent new and 20 percent from prior years' procurements).

The individual contract pricing terms could require a single fixed price for the duration of the contract or could require pricing vary by year or month. The prices could be translated into rates directly or averaged. Also, as is currently done, prices could be obtained by zone and customer class.

There is a significant degree of flexibility in this type of laddered portfolio approach. The spot component may be used to absorb some of the effects of migration by allowing the other components to be procured as fixed percentages of peak rather than load following tranches. The procurements could be designed to allow for some level of purchasing freedom that would permit the utility to take advantage of market opportunities that occur outside of the annual procurement period. If experience indicates that shorter or longer term contracts provide better benefits, the length of the contracts may begin to reflect this with the next annual procurement.

The Department also asked whether, for any specific proposals, the Department currently has the statutory authority for implementation or whether specific statutory changes should be considered. It is not the Attorney General's intention to submit a specific proposal, but rather to present options for the Department's consideration.

RESPONSE:

The Department has general supervisory authority over the electric companies. G.L. c. 164, § 76. "General Laws Chapter 164, Section 1 B(d) requires the following: 1) that each distribution company provide default service, 2) that default service be competitively procured, 3) that the default service rate 'shall not exceed the average monthly market price of electricity,' and 4) that bids to supply default service 'shall include payment options with rates that remain uniform for periods of up to six months.'" D.T.E. 99-60, p. 1. The Department also has the authority "to promulgate rules and regulations necessary to carry out the provisions of [§ 1B], including the procedure for default service procurement..." G.L. c. 164, § 1B (f).

If the Department were to implement a statewide auction and longer contract terms, utilities would still provide default service, the auction would consist of competitive bidding, with pricing options as currently available and, through the procurement of default service through spot pricing, rates that would remain fixed for no more than six months as set forth in the default service statute. *See* G.L. c. 164, § 1B(d). Whether additional legislative approval is required will depend on the specific changes to the current procurement policy.

Respectfully submitted,

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cc: Service List for D.T.E. 02-40